Internal Revenue Service

memorandum

CC:TL-N-3518-88
Br3:FJElward

date: JUN 22 1989

to: District Counsel, Honolulu W:HON

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Deductibility of "Blight of Summons" Damages

Tax Litigation Advice

Your memorandum of February 3, 1989 requested our advice on a technical advice which you propose to send to the district director on whether amounts paid as "blight of summons" damages incident to the purchase of the fee simple interest in residential real property under the Hawaii Land Reform Act of 1967 (HAWAII REV. STAT. §§ 516-1-186), herein merely referred to as the Act, represent deductible interest within the meaning of I.R.C. § 163.

The following facts are a summary of the facts stated in your request, as supplemented and the attachments to your request.

The state of Hawaii by the Act established a procedure for certain lessees to acquire the fee simple interest in their leasehold by use of the power of eminent domain. The Act provides that the exercise of the power of eminent domain under the Act is to be "... in the same manner as provided in [HAWAII REV. STAT.] Chapter 101." The reference is to the general eminent domain statute.

A taking under the Act is initiated by the lessee filing a petition with the Hawaii Housing Authority, the Authority, the state agency which actually initiates the condemnation. There are various requirements as to the property that can be taken under the Act and requirements as to the lessees permitted to file such a petition, e.g., proof of financial ability to complete the purchase. While the Act permits the use of state money to acquire property, the practice of the Authority is to use only money from the lessees to acquire property under the Act. The Authority is permitted to sell property acquired under the Act to persons other than the lessees if the lessee does not choose to complete the purchase; however, in practice

the proceedings are abandoned if the lessee does not desire to complete the acquisition. Thus the fee interest in the property remains with the lessor if the lessee does not complete the acquisition.

The lessor is entitled to receive the fair market value of the property taken under the Act. The property is valued at the time the condemnation is begun. To compensate the lessor for the delay between the time of the valuation and the time he actually receives compensation, an additional sum is paid. The additional sum is called "blight of summons" damages (hereinafter "damages"). You state that the amount of the damages is a matter of negotiation and there is no set formula; however, HAWAII REV. STAT. § 101-25 appears to require the damages equal to interest at a rate of 5% per annum. But you state that at least in one case no damages were paid. The commercial interest rates and changes in the value of the property between the valuation date and the actual payment date are relevant considerations. Hawaii Housing Authority v. Midkiff, __ Haw. __ , 739 P.2d 248 (1987). The amount of damages paid are reduced by the rent paid to the lessor during the pendency of the proceeding.

[redacted]

Your information indicates that various taxpayers are deducting the damages as interest. The group includes not only the persons who acquired land under the Act, but also those who acquire land by settlement with the lessor before the proceedings under the Act are concluded and even those who acquire the fee from the lessors by agreement without recourse to the Act.

You state that the Internal Revenue Service has taken the position that the damages are not deductible as interest and is preparing to issue notices of deficiency to a large number of taxpayers.

You specifically request advice on the first two categories of taxpayers mentioned, i.e., those who acquire the fee by use of the Act and those who acquire fee by settlement of the proceedings under the Act before trial. (In the first group the blight damages are set by the court. In the second group they are determined by agreement of the parties.)

You conclude that for a number of reasons the damages are not deductible as interest, mainly because damages appear to be an additional award for delay in receiving payment for the

property between the valuation date and the date compensation is received and there does not appear to be an indebtedness. There are no cases directly in point. A number of cases have dealt with the tax treatment of damages by the lessors, but no case has dealt with the question presented in your request.

With numerous limitations, I.R.C. § 163(a) provides for the deduction of interest paid or accrued within the year on indebtedness. The four elements necessary to prove an interest deduction are (1) there must be an indebtedness; (2) the indebtedness must be that of the taxpayer; (3) the interest must be paid or accrued on the indebtedness; and (4) such payment or accrual must be within the taxpayer's taxable year.

Two major restrictions on the deductibility of interest are the limitation on the deduction of personal interest and the limitation on the deduction of investment interest. These limitations are beyond the scope of this tax litigation advice.

In the present case the blight of summons damages are compensation to the lessor-fee owner for the delay in payment of the fair market value of its property since the value of the property is determined on the summons date, but the lessor-owner does not receive payment for a considerable period of time after that date. The tax treatment by the lessor-fee owner has been litigated in Ferreira v. Commissioner, 57 T.C. 866 (1972), in which the Tax Court upheld the Commissioner's determination that the blight damages must be reported as ordinary income rather than capital gain. The Tax Court relied on Kieselbach v. Commissioner, 317 U.S. 399 (1943), a condemnation case which considered the question of whether a portion of the award should be treated a ordinary income or capital gain. The issues in these cases are different from the issue here. Here the taxpayer must establish that all the requirements of § 163 have been met, in the cases mentioned, the issue was whether the requirements for capital gain treatment were met. These are distinctly different questions.

The first requirement for deduction of interest is that the taxpayer pay or accrue interest. Interest is the amount paid per unit of time for the use of borrowed money. Thompson v. Commissioner, 73 T.C. 879, 887 (1980), acq., 1972-2 C.B. 2. Interest is also said to be the amount which one has contracted to pay for the use of borrowed money which represents indebtedness. Old Colony R. Co. v. Commissioner, 284 U.S. 552 (1932), Deputy v. du Pont, 308 U.S. 488 (1940). In general, indebtedness is: "... an existing unconditional and legally enforceable obligation to pay." Mertens Law of Federal Income Taxation, § 26.09, notes 40 through 42.

As you note in your request, the Court in Kieselbach seemed to indicate that the damages paid to the land owner need not be considered interest since if not interest they may be compensation for the delay in payment of the award. Thus, it does not follow that compensation for delay in payment of a condemnation award is necessarily interest although it might be calculated the same way interest is calculated. Further, since the tenant-purchaser is not bound to make the purchase, there does not appear to be a binding obligation to pay interest on indebtedness. In addition, the obligation to pay the blight damages technically runs from the Hawaii Housing Authority to the lessor-owner so it might be argued that to the extent there is an indebtedness, it is the indebtedness of the Hawaii Housing Authority and not that of the lessee.

In sum, the blight damages are not interest paid or accrued by the taxpayer on an indebtedness which is his.

We have no objection to your proposed technical advice to the district director, but since the issue is one of first impression, we have referred it to the Assistant Chief Counsel (Financial Institutions and Products). We are still awaiting a response. We suggest that, if possible, you withhold issuing technical advice to the district director until we have received and forwarded to you the response we receive from the Assistant Chief Counsel (Financial Institutions and Products).

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